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37213—38——1

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 446

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELBE OIL LAND DEVELOPMENT COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 69–76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals (R. 86–91) is reported in 91 F. (2d) 127.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 21, 1937 (R. 91). The petition for a writ of certiorari was filed September 21, 1937, and granted November 8, 1937 (R. 92). The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1927 the taxpayer sold all its interest in certain oil and gas leases, including equipment, in consideration of a cash payment of $350,000, and of further payments of $400,000 on the fourteenth day of March of each of the years 1928, 1929, and 1930, and of $450,000 on March 14, 1931, or a total of $2,000,000. The agreement provided that the purchaser might elect to abandon the purchase before making either the 1928 or 1929 payments. It further provided that from and after the time when the purchaser should have been reimbursed, from the sale of oil and gas from the properties, for all expenditures made in the acquisition, development, and operation of the properties, the purchaser should pay to the taxpayer one-third of its net profits, as therein defined, from the operation of the properties.

The question is whether, under Section 114 (b) of the Revenue Act of 1928, *infra*, the taxpayer is entitled to a depletion deduction of 27½ per cent of the cash installment payments received in each of the years 1928 and 1929.

STATUTE INVOLVED

The Revenue Act of 1928, c. 852, 45 Stat. 791, provides in part as follows:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *

(1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * *

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SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) Basis for depletion.—

* * * * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the prop-

> erty during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

STATEMENT

Respondent, a California Corporation, was organized on February 4, 1925. It acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases, and equipment. Development work carried on by it resulted in the discovery of oil, and on October 3, 1927, oil was being produced in commercial quantities. (R. 34, 70.)

As of October 3, 1927, under the terms of a written agreement (R. 37–64), the taxpayer sold, assigned, transferred, and conveyed all its right, title, and interest in and to certain described prospecting permits, drilling agreements, leases, and equipment to the Honolulu Consolidated Oil Company (hereinafter referred to as Honolulu), the latter to "have the sole ownership of and the right to sell or otherwise dispose of, all oil and/or gas and derivative products produced in, on or upon said properties," it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in HONOLULU * * * and ELBE [the taxpayer] shall have no interest in or

to any of said properties whatsoever." (R. 45.)

The consideration to be paid the taxpayer, as set forth in paragraph 7 of the agreement, was $350,000 in cash upon execution of the agreement, and thereafter, if Honolulu did not elect to abandon the purchase before making either of the two succeeding payments, as provided by paragraph 9 of the contract, the sum of $400,000 on the fourteenth day of March of each of the years 1928, 1929, and 1930, and $450,000 on March 14, 1931, together with interest as specified (R. 34, 47–48, 71). Of such $2,000,000 to be received by the taxpayer, the amount of $1,963,672.95 was consideration for the oil and gas rights in the leases and the remainder was consideration for equipment and other property conveyed (R. 35, 71). The consideration of $2,000,000 was to be paid without reference to, and without being in any manner based upon, the production of oil from the properties (R. 71).

The agreement, in paragraph 8 thereof (R. 48–54), provided that "from and after the time" when Honolulu should have been reimbursed from its sales of oil and gas from the properties for all expenditures made in the acquisition, development, and operation thereof, it should pay to the taxpayer 33⅓ per cent of its net profits, as therein defined, resulting from the production and operation of the properties (R. 48, 72). Up to the date of the hearing before the Board, no payments became due or were made to the taxpayer by Honolulu under the terms of paragraph 8 (R. 35, 72).

The agreement, in Paragraph 12 thereof, provided that, anything contained therein to the contrary notwithstanding, it was the intention of the parties that the full ownership, possession, and control of all the properties should vest in Honolulu and that Elbe should have no interest whatsoever in the properties (R. 61).

The taxpayer has received each of the payments in the amounts and on the dates specified, totaling $2,000,000. The cost to the taxpayer of all the assets transferred under the agreement was less than the amount of $350,000 received in 1927. In its return for that year the taxpayer treated the transaction as a sale and reported as taxable income the difference between the cost basis of the property and the payment received in that year (R. 35, 71).

In filing its income tax returns for the years 1928 and 1929, the taxpayer reported as income the $400,000 payment received in each of those years, and claimed as a deduction 27½ per cent thereof as an allowance for depletion (R. 35–36, 71–72). The Commissioner of Internal Revenue determined that the taxpayer was not entitled to any deduction for depletion (R. 36), and his action was affirmed by the Board of Tax Appeals (R. 69–77). Upon appeal the Circuit Court of Appeals reversed the decision of the Board, holding that percentage depletion was allowable on the cash installment payments received in each of the years 1928 and 1929. One judge dissented (R. 90).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer was entitled to a 27½ per cent depletion allowance on the cash payments it received in each of the years 1928 and 1929.

2. In holding that the taxpayer retained such an interest in the oil and gas in place as entitled it to depletion allowances on the cash payments received in each of the years 1928 and 1929.

3. In holding that the taxpayer is entitled to depletion allowances for the years involved.

4. In reversing the Board of Tax Appeals.

SUMMARY OF ARGUMENT

I. Apart from the provisions of the agreement whereby Honolulu undertook to pay the taxpayer one-third of its net profits after reimbursement for all expenditures, the respondent beyond question would have no basis for a claim to depletion upon the cash payments. The payments were not made out of production, nor are they to be regarded as dependent upon production merely because the taxpayer might have abandoned the purchase before making them. The payments were expressed to be the consideration for a sale; and the taxpayer itself in a previous return so treated an earlier payment. The effect upon the character of the payments of the respondent's contingent right to share in future net profits ought not to be considered in the absence

of any showing of a reasonable expectation that such right will become operative.

II. Even if the payments to which respondent is contingently entitled in the future be regarded as royalties subject to depletion when made, the present cash payments cannot properly be treated as a bonus or advance royalties. The decisive circumstance setting this case apart from the cases of a bonus heretofore decided by this Court is that Honolulu, having paid $2,000,000 to Elbe, is entitled to reimburse itself for this and all other expenditures before any further payments are made. With respect to the oil to which Honolulu looked for reimbursement the transaction was in substance a sale. The payments were not advance royalties for the right of extracting oil and gas which would be allocable, in computing Honolulu's depletion allowance, to production throughout the life of the well. They were advance payments for oil of a determinate and presumably equivalent amount allocated by the parties themselves to the first oil to be produced and saved. With respect to all oil produced until reimbursement is complete, Honolulu is solely entitled to the depletion allowance. It owns the oil and receives the "gross income from the property." Its position is indistinguishable from that of assignors who have retained the right to receive oil up to a designated amount and who have been held to be entitled to depletion. *Thomas* v. *Perkins,* 301 U. S. 655. The circumstance that current production dimin-

ishes the source available for future payments to respondent is irrelevant. Honolulu is in the same position.

III. A right to a specified proportion of the net profits of an operator of an oil or gas well does not give rise to a depletable interest in the oil in place since the holder thereof does not own the oil produced and does not receive "gross income from the property." The impossibility of regarding the contingent payments provided for in the present case as "gross income from the property" is emphasized by the elaborate mechanism set up for their computation. Since the respondent would not be entitled to depletion upon the payments of a share of Honolulu's net profits, if made, the existence of a contingent right to such payments cannot alter the character of the cash payments here in question.

ARGUMENT

The theory of Congress in permitting a deduction for depletion is that it will compensate the owner of a wasting asset for the exhaustion sustained in the production of taxable income. A capital interest in the mineral in place is, therefore, a prerequisite of the right to a depletion allowance. This interest, however, need not consist of any form of legal ownership of the mineral content of the land. What is essential is that the taxpayer be entitled to a share of the mineral produced, or

of its gross proceeds. *Palmer* v. *Bender,* 287 U. S. 551; *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312. "If so he has an economic interest in the oil, in place, which is depleted by production." *Palmer* v. *Bender,* 287 U. S. at 557.

The depletion allowance is a percentage of "gross income from the property," which means gross income from oil and gas. *Helvering* v. *Twin Bell Oil Syndicate, supra.* The decisions of this Court have uniformly confined the right to participate in the allowance to persons entitled to payments out of oil or the gross proceeds of oil, and have permitted the deduction only from such payments themselves or from cash payments which could be regarded as advance royalties paid in anticipation of the extraction of oil. They uniformly recognize that the right thus to share in the oil as it comes from the well is indispensable to ownership of a depletable interest in the oil in place.

In *Thomas* v. *Perkins,* 301 U. S. 655, 661, this Court in discussing the *Palmer* case said:

> Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save them an economic interest in the oil sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential.

If, as this Court thus stated, ownership of the oil is essential, the decision under review cannot be supported.

I

THE TRANSACTION WAS CLEARLY A SALE BY ELBE TO HONOLULU UNLESS ITS CHARACTER WAS CHANGED BY THE PROVISIONS OF PARAGRAPH 8 FOR ULTIMATE PAYMENT TO ELBE OF A SHARE OF HONOLULU'S NET PROFITS

Apart from the provisions of paragraph 8 whereby Honolulu undertook to pay Elbe one-third of its net profits after reimbursement for expenditures, the taxpayer beyond question would have no basis for a claim to depletion upon the present payments. The case in this aspect differs sharply from *Thomas* v. *Perkins, supra.* There oil leases were assigned in terms of outright sale in consideration of an agreement to pay $395,000 in periodic payments which were to be one-fourth of all the oil produced and saved, and which were to be due only if, as, and when oil was produced. Thus, in that case the making of the payments and the amount of each payment (until the total was paid) were wholly dependent upon production. The payments were to be made out of production. Upon the ground that a certain proportion of oil had thus been withheld from the grant, the assignors were declared to be entitled to depletion. In the instant case payments of a prescribed amount were to be

made, as the Board found (R. 71), without reference to the production of oil or gas from the properties; and there is no basis for suggesting that any oil was withheld from the grant. The two payments here involved clearly do not constitute income from production merely because Honolulu had the right, before making either of them, to abandon the purchase of the properties. The most that can be said is that Honolulu made the payments expecting ultimately to be reimbursed from production.[1] There is a similar expectation in the case of any sale, be it subject to an option or absolute.

The agreement between Honolulu and the taxpayer specifically provided that it was the intention of the parties that full and complete ownership of the properties should vest in Honolulu and the taxpayer should "have no interest in or to any of said properties whatsoever" (R. 45). Such sweeping language could find no proper place in any instrument but that of a contract of sale. It is clear that payments made pursuant to a sale, which are not derived from production, are not subject to depletion. *Darby-Lynde Co.* v. *Alexander,* 51 F. (2d) 56 (C. C. A. 10th), certiorari denied, 284 U. S. 666.

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[1] Thus, Honolulu might well have acquired the property as a reserve though no production whatever had occurred, or it might have elected to abandon the purchase, in view of market conditions or development of other properties, even though production was actually taking place.

That the transaction was a sale and not a sublease is further shown by the fact that the taxpayer treated it as a sale in its income tax return for 1927, the year the transaction was consummated. For that year it reported a profit of $83,444.58 from the transaction by deduction from the cash payment of $350,000 of the entire cost basis of the properties so transferred. Thus, the taxpayer has already received a return of its capital investment. This being so, it seems clear that it is not entitled to further deductions under the guise of depletion allowances.

If the transaction was not a sale, it must be because the terms of absolute conveyance in the instrument are to be treated not merely as "qualified" (*Thomas* v. *Perkins,* 301 U. S. at 659) but as nullified by the contingent rights elsewhere conferred upon Elbe ultimately to share in Honolulu's net profits. The record is barren of evidence to show that any reasonable expectation exists that payments ultimately will be made under paragraph 8. The Commissioner ruled that (R. 15, 16)—

> The consideration of $2,000,000.00 is definite as to amount and periods of payment and it was the entire known consideration when the contract was executed. The possibility of the taxpayer sharing in the net profits from the operation of the properties conveyed was contingent upon profits being earned great enough to extinguish the full

costs of acquisition and development.
* * *

The Board of Tax Appeals held that the nature of the cash payments made by Honolulu was unaffected by its "wholly contingent obligation for future payments under its contract of purchase" (R. 72). The burden is upon the taxpayer to establish its right to the depletion allowance. Compare *Reinecke* v. *Spalding*, 280 U. S. 227, 232; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 308. In these circumstances we think that in the absence of a showing that paragraph 8 was something more than a paper provision, the holding of the Board that the payments in question constituted proceeds from the sale of a capital asset should have been affirmed.

Treating the question of the respondent's rights under paragraph 8 as open, and conceiving that the provision vested in the respondent a royalty interest,[2] entitling it to depletion upon any payments made thereunder, the court below held that the cash payments here in question were "in effect a guarantee of future oil production and made because of such anticipated production" (R. 90), and constituted, therefore, advance royalties likewise subject to depletion.[3] Compare *Burnet* v. *Harmel*, 287

[2] By inadvertence the court mistakenly described this interest of the respondent (R. 87) as a right "to receive one-third of all oil produced."

[3] Judge Haney concurred "solely on the ground that although *Palmer* v. *Bender*, 287 U. S. 551 is distinguishable on its facts, the language used therein is general enough to embrace the facts herein." Judge Garrecht dissented (R. 90).

U. S. 103; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Herring* v. *Commissioner*, 293 U. S. 322.

In so holding, we think the court below was doubly in error. The respondent did not acquire a royalty interest by virtue of its contingent rights under the contract to share in Honolulu's net profits from the operation of the leases. Nor, if it had, would it follow that the present cash payments are to be treated as depletable advance royalties. The latter point, being the short answer to the taxpayer's principal contention, may appropriately be discussed first.

II

CASH PAYMENTS RECEIVED FROM ANOTHER WHO IS ENTITLED TO REIMBURSEMENT FROM PRODUCTION ARE NOT SUBJECT TO DEPLETION

The respondent urges that the making of the payments here in question reduced the quantity of oil available as a source of future payments under paragraph 8, since Honolulu was entitled to be reimbursed for them out of production before the later payments were made. "Thus in effect", it is said (brief in opposition to petition for certiorari, p. 7), "each payment here was but advance or minimum royalty."

Depletion which is allowed to Elbe evidently must be denied to Honolulu. Percentage depletion cannot be claimed upon an aggregate basis in excess of 100 percent of the gross income from the property. *Helvering* v. *Twin Bell Oil Syndicate,*

supra. Before the provisions of paragraph 8 become operative, $2,000,000 worth of oil must be extracted from the property—plus an amount sufficient to reimburse Honolulu for all other expenditures as defined in the agreement. Honolulu concededly will be entitled to percentage depletion upon this excess over $2,000,000. With respect to the $2,000,000 worth of oil, however, the allowance if given to Elbe upon the so-called advance payments must be denied to Honolulu when actual production of the oil takes place.

The insufficiency of the argument advanced in support of Elbe's claim to depletion to the exclusion of Honolulu must be apparent, for it is one which could equally well be made by Honolulu in support of a claim to depletion to the exclusion of Elbe. Honolulu, like Elbe, has a right to share in the net profits under paragraph 8 of the agreement. Extraction of oil in advance of the time when that paragraph becomes operative diminishes the value of Honolulu's right no less than that of Elbe's. If an interest in *future* production (assuming that Elbe has such an interest) suffices as a basis for depletion with respect to current production, both parties in the present situation would be equally entitled to the allowance.

The respondent's contention, we submit, rests upon a fundamental misapprehension. Depletion represents capital *extracted* from the property, not capital which is still in the ground. The right to depletion with respect to oil produced during any

particular period must therefore depend primarily upon ownership of *that oil,* not upon ownership of the oil in the ground. The interests of the parties in future production, under paragraph 8, is thus irrelevant. The decisive consideration is the interest of the parties with respect to the $2,000,000 worth of oil to be produced prior to that time. With respect to that oil, the respondent clearly has no longer a capital interest. It has been paid in full. It is Honolulu which must look to the oil produced before paragraph 8 comes into operation for a return of its capital. Until that time, the entire "gross income from the property" is Honolulu's. Under the statute Honolulu is therefore entitled to depletion. For the present, Honolulu has that ownership of oil *as produced* which this Court, in *Thomas* v. *Perkins, supra,* said was essential. Indeed, if there is not enough oil in the well to permit either party to enjoy "net profits" under paragraph 8, Honolulu—economically as well as legally—owns not only the oil currently produced but *all* the oil in place.

The decision of this Court in *Thomas* v. *Perkins, supra,* we think is controlling of the case at bar. There Hammonds and Bronson assigned to Perkins all their interest in certain oil leases in consideration of the right to receive one-fourth of all oil produced and saved up to the aggregate amount of $395,000. The Court held that the transaction amounted to a retention by the assignors of sufficient oil to produce such an amount, and that the

assignors were entitled to depletion upon the oil so produced. This decision was reached without regard to the circumstance that Perkins as owner of the residuary interest in the well was the party primarily affected by extraction of the oil necessary to make up the stipulated payments. Ownership of the *oil produced,* the Court held, was controlling with respect to the right to deduct percentage depletion from the gross income from that oil. The only possible distinction between the case at bar and that case is that Honolulu has *acquired* instead of *retained* the right to receive sufficient oil to produce a designated amount. The difference between a grant and a reservation from a grant assuredly is without importance here. In all material respects the two cases are indistinguishable. Like Perkins' assignors, Honolulu undoubtedly owns the oil as produced. Like them it receives the "gross income from the property." Perkins' assignors bore the risk that sufficient oil would be in the well to complete the payments. It was they who were looking to the oil paid over to them for a return of capital. Honolulu similarly bears the risk that sufficient oil will be in the well to reimburse it. Honolulu similarly is looking to the oil produced—until the reimbursement is complete for a return of its capital. Unlike Perkins' assignors, moreover, Honolulu is entitled to the *whole* of production until such reimbursement has taken place, and unlike them also it has a residuary interest in the oil thereafter in the well.

The payments in question, it seems apparent, are not advance royalties. A royalty is a payment in the nature of rent for the right of extracting oil and gas from the property. It is a share of production given by the operator of the well in return for the right to reduce the remaining share to ownership. A bonus paid upon the signing of an oil lease is regarded as an advance royalty, and held to be depletable, upon the theory that it represents an additional share of production given for the right of extracting oil from the property and is, therefore, of essentially the same character as the royalty itself. "The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease * * *." *Burnet* v. *Harmel, supra,* 287 U. S. at 106. It is settled that the depletion allowance is to be apportioned between the parties interested in production according to their interest. *Helvering* v. *Twin Bell Oil Syndicate, supra.* To deny depletion to the lessor upon the bonus payment, this Court has considered, would be to apportion the allowance between the parties in disregard of their actual interest. Compare *Herring* v. *Commissioner, supra,* 293 U. S. at 327.

The present payments are not under any view payments of a share of production made in return for the right of operating the well and retaining the balance. They are payments made in return for the right of retaining oil of a determinate

amount. They are not, therefore, advance *royalties* for the right of extracting oil and gas. They are advance *payments* for oil and gas of a presumably equivalent amount—namely, the amount necessary to reimburse Honolulu for all its expenditures in connection with the property. *Pro tanto* the transaction constitutes a purchase of an economic and legal interest in the oil in place—and this regardless of the nature of the parties' relationship once Honolulu has reimbursed itself and the provisions of paragraph 8 become operative.

The decisive circumstance setting this case apart from the cases of a bonus heretofore decided by this Court is that Honolulu, having paid $2,000,000 to Elbe, is entitled to reimburse itself for this and all other expenditures before any further payments to Elbe are to be made. With respect to the first $2,000,000 worth of oil extracted from the property, therefore, the question is not one of apportionment of the depletion allowance as between lessor and lessee. The question is one of giving the deduction in full to the one party or to the other. As between Honolulu and Elbe, it seems clear that Honolulu has the depletable interest.

A true bonus—under the prevailing and plainly correct practice of the Bureau of Internal Revenue—is spread over the entire expected production of the well in computing the depletion allowance of the operator.[4] The allocation is accomplished by

[4] See Treasury Regulations No. 77 (1932), Art. 221 (g): "Where royalties in the form of bonus pay-

deducting from the actual gross proceeds of the operator in the year of production—in order to arrive at the operator's "gross income from the property"—an amount per barrel equal to the total estimated number of barrels in the well divided by the amount of the bonus.[5] Such a procedure would be obviously inappropriate in the present case. The sums here in question were not paid for the right of extracting oil or gas throughout the life of the well. They are not therefore allocable to the entire expected production. They are amounts paid for the right of retaining a determinate amount of oil. The terms of the agreement forbid their being spread throughout the life of the well. They are not royalties, therefore, but advance payments allocated by the parties themselves to the first oil to be produced and saved.

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ments or advanced royalties (see article 230) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year." This provision was adopted following the decision of this Court in *Herring* v. *Commissioner*, *supra*.

[5] To illustrate: A well containing an estimated 400,000 barrels of oil is leased—the lessor receiving $100,000 in cash and a one-eighth royalty. Upon the 350,000 barrels which the lessee will obtain, he has thus paid an advance royalty of $.35 a barrel. If the lessee's share of the first year's production is 10,000 barrels, the sum of $3,500 will be deducted from the gross proceeds thereof as representing advance royalties. The lessee's deduction for depletion will be 27½ per cent of the remainder.

The decision of the court below is in substantial conflict with that of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming*, 82 F. (2d) 324. There the taxpayer and other leasehold owners in 1929 had sold a lease for $175,000 in cash and the further sum of $225,000 to be paid out of one-half of seven-eighths of the first oil produced and saved. During that year the taxpayer received $43,750 as his share of the cash payment and also $9,578.17 from oil runs. In harmony with the subsequent decision of this Court in *Thomas* v. *Perkins, supra,* the court held that the receipts from oil runs were subject to depletion. As to the cash payment which was not dependent upon production, it held the contrary. As in this case, the payment evidently was not a bonus paid for the privilege of extracting oil. It was the consideration for the purchase of all the oil save that reserved by the grantors. The transaction differs from the present case only in that the taxpayer, instead of selling oil of a determinate amount, sold all the oil except a determinate amount. In neither case did the taxpayer retain any interest in the oil with respect to which the deduction for depletion was claimed.

We submit that with respect to the oil to which Honolulu looked for reimbursement the transaction was in substance a sale. The concept of a bonus as an advance royalty cannot be extended to include sums paid for the right to extract an equivalent amount of oil from the ground.

III

THE TAXPAYER DID NOT ACQUIRE A ROYALTY INTEREST UNDER THE PROVISIONS ENTITLING IT TO RECEIVE A SHARE OF THE PURCHASER'S NET PROFITS AFTER THE PURCHASER HAD BEEN REIMBURSED FOR ALL EXPENDITURES

In the view of the case which has been taken, the nature of the interest acquired by Elbe under the provisions of paragraph 8 is of no consequence. For the reasons stated in the brief for the United States in No. 406 (pp. 7–11), however, we think it clear that Elbe would not be entitled to percentage depletion upon any payments which may be made under that provision. A right to a specified proportion of the net profits of an operator of an oil or gas well does not give rise to a depletable interest in the oil in place since the holder of such a right does not own the oil as produced and does not receive "gross income from the property." *Palmer* v. *Bender, Helvering* v. *Twin Bell Oil Syndicate, Thomas* v. *Perkins,* all *supra.*

The impossibility of regarding the payments provided for in paragraph 8 as "gross income from the property" is emphasized by the elaborate mechanism set up for their computation. Reimbursement of Honolulu is to be computed by deducting from the market value at the well of gas and oil produced and saved 7½ per cent as to certain leases and 5 per cent as to others (R. 48, 49). A similar deduction is to be made in computing net profits (R. 52). Moreover, Elbe agrees to pay to

Honolulu out of its share of the first of the net profits, if any, interest at the rate of 2½ per cent per annum upon all expenditures made or incurred by Honolulu in the development and operation of the property, including the cost of acquisition from Elbe. It is apparent, we think, that Elbe is in no sense entitled to receive even net income *from production.* Rather is it a contingent promisee upon a personal covenant to pay indeterminate sums of money to be computed according to a special formula.

Since the respondent would not be entitled to depletion upon the sums ultimately payable under paragraph 8, the existence of a right to such payments under the contract cannot affect the character of the cash payments actually received. The decisions permitting deductions for depletion from bonus payments are confined to situations in which the taxpayer has indubitably acquired a depletable interest by virtue of a right to royalty payments out of oil or the proceeds of oil. Only because of that interest can the lump sum payments be regarded, in any view, as advance royalties in anticipation of the extraction of oil.

The respondent suggests (brief in opposition to petition for certiorari, pp. 8–10) that payments of net profits to one in its position must be treated as "gross income from the property" in view of the further provision of the statute that the allowance for depletion "shall not exceed 50 per centum of the net income of the taxpayer (com-

puted without allowance for depletion) from the property." The argument is that the net income of Honolulu from the property, within the meaning of the limitation, would exclude the share of net profits payable to Elbe; and that the effect of including that share in Honolulu's gross income would therefore be to cut it out "without any accounting at all." No argument or authority is offered to show that the amounts payable to Elbe would not be included within Honolulu's net taxable income. In any case, "net income * * * from the property" is not necessarily synonymous with net taxable income. We think it clear that the amounts payable to Elbe, since they are not, as regards Elbe, income "from the property" would be includable within Honolulu's "net income * * * from the property" for the purposes of the limitation; and that such amounts accordingly would receive their full accounting in computing Honolulu's depletion allowance. But were this not so, the respondent's contention would still be unpersuasive. The asserted exclusion of the amounts in question from "an accounting" would not be invariable, but would depend upon the amount of the operating expense and the size of the share of net profits payable in the particular case. Percentage depletion is merely a "statutory rule of thumb" (brief in opposition, p. 11). The operation of such a rule, on occasion, with apparent arbitrariness is no ground for rejecting a meaning which otherwise is plain.

CONCLUSION

For the reasons stated it is respectfully submitted that the judgment of the Circuit Court of Appeals is erroneous and should be reversed.

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In the Supreme Court

OF THE

United States

October Term, 1937

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

v.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENT IN OPPOSITION

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GUY T. HELVERING, Commissioner of Internal Revenue,
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v.
ELBE OIL LAND DEVELOPMENT COMPANY,
Respondent.

BRIEF FOR THE RESPONDENT IN OPPOSITION

Opinions Below

The opinion of the Board of Tax Appeals (R. 69-76) is reported in 34 B. T. A. 333. The opinion of the Circuit Court of Appeals (R. 86-91) is reported in 91 Fed. (2d) 127.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered June 21, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the *Judicial Code*, as amended by the Act of February 13, 1925.

Question Presented

The question is whether the annual payments of $400,000 each received by the taxpayer in the years 1928

and 1929 under an agreement dated October 3, 1927, were "gross income from the property" within the meaning of that phrase as used in Section 114 (b) (3) of the *Revenue Act of 1928,* so as to entitle the taxpayer to a depletion allowance of 27½ percent thereof under the provisions of that section.

Statutes Involved

The statutes involved will be found in the Appendix, *infra,* pp. 13-14.

Statement

The statement in the petition summarizing the facts is inaccurate, incomplete, and in conflict with the record. Under the heading of "Question Presented," page 2 of the Petition, the Commissioner makes a preliminary statement of the facts, involving a transfer of properties by the taxpayer to Honolulu Consolidated Oil Company (hereinafter referred to as Honolulu) under an agreement dated October 3, 1927; but he fails to make clear that with respect to each payment here in question, that is, those in 1928 and 1929, Honolulu had the election on the date specified to either make the payment or return the properties to the taxpayer. In case it elected to return the properties to the taxpayer it retained the right to the possession of all oil wells which had been completed or were in the process of drilling until such time as it had been reimbursed for all its expenditures, including the payments already made to the taxpayer. This right of election is embodied in paragraph 9 (R. 54-59) of the agreement dated October 3, 1927.

Again, under the heading of "Statement," page 4 of the Petition, the Commissioner quotes from paragraph 3 (R. 44-45) of the agreement of October 3, 1927, but in effect misquotes that paragraph by omitting therefrom the words "Subject to the provisions of Paragraph 9." On page 6 the Commissioner repeats this omission in stating the substance of paragraph 12 (R. 61). Thus by misquotation by means of omission the Commissioner has essayed to create the erroneous impression that the contract of October 3, 1927, contained recitals of a complete transfer by the taxpayer of its ownership in the properties involved, when those very recitals, even disregarding reservations in other provisions of the contract, denied a complete transfer of ownership.

Furthermore, on page 5 of the Petition, and again on page 8, the Commissioner states that the "consideration of $2,000,000 for such sale was to be paid without reference to, and without being in any manner based upon, the production of oil from the properties conveyed." This is a mere inference entirely unsupported by the record. There was nothing in the agreement of October 3, 1927, preventing Honolulu from basing its election to make a payment or return the properties on the actual results of production of oil from the properties. That the election would necessarily be based on such actual results of production of oil is obvious from the fact that the properties transferred consisted only (R. 39-43) of *oil and gas* prospecting permits, *oil and gas* drilling agreements, *oil and gas* leases, and *oil and gas* producing equipment. The Commissioner, in an effort to avoid such a conclusion, actually concedes it. He says, on page 9 of the Petition,